The Case for Facilitating Competing Tender Offers: A Reply and Extension

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In a recent article[1] and in this exchange,[2] Professors Easterbrook and Fischel argue that the facilitation of competing tender offers is undesirable. They contend that in regulating corporate takeovers the overriding consideration should be to encourage the search for takeover targets by prospective acquirers. Accordingly, they favor minimizing the premiums paid to targets' shareholders, since reducing these premiums would increase the return on prospective acquirers' search. And impeding competing bids would sharply decrease takeover premiums. Indeed, because a target's dispersed shareholders are under pressure to tender, eliminating competition among acquirers would lead to very low premiums.[3]

Professor Gilson and I, in our respective articles, disputed Easter-

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1. Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1175-80 (1981) [hereinafter cited as Easterbrook & Fischel, *The Proper Role of a Target's Management*].

2. Easterbrook & Fischel, *Auctions and Sunk Costs in Tender Offers*, 35 STAN. L. REV. 1 (1982) [hereinafter cited as Easterbrook & Fischel, *Auctions and Sunk Costs*].

3. The pressure on shareholders to tender and its implications are described in detail in Bebchuk, *The Case for Facilitating Tender Offers*, 95 HARV. L. REV. 1028, 1039-41 (1982). When each small shareholder decides whether or not to tender, he will realize that the effect of his decision on the tender offer's success in attracting a majority of shares will be insignificant. The shareholder will therefore consider whether, supposing the offer is successful, he will be better off tendering or holding out. He will choose to tender because it is expected that, following the expiration of a successful offer, the value of nontendered shares will be lower than the offer's value; for one thing, a successful offer may well be followed by a freezeout in which the value of the consideration paid to nontendering shareholders will be lower than the offer's value. Thus, the shareholders will be pressured to tender even if acceptance of the offer is not in their collective self-interest. Consequently, if competing bids are impeded, an offeror will be able to acquire a target for a low premium constituting only a small fraction of the takeover's gains—a premium that the shareholders would likely reject were they able to organize.

brook and Fischel's thesis.[4] In my response, I demonstrated that facilitating competing bids has significant beneficial effects from the perspectives of both target shareholders and social wealth. I also questioned the magnitude, and even the existence, of the adverse effect that Easterbrook and Fischel claimed competition among acquirers has on offer frequency.

The most important implication of this debate concerns the regulation of offerors. Potential competing bidders, whether or not they receive information from the target's management, need time. A target's dispersed shareholders, under pressure to tender, are unable to act in concert to provide the necessary delay. Regulations that prescribe a mandatory delay period are thus crucial for competing bids. Consequently, I endorse such regulations and Easterbrook and Fischel oppose them. They would repeal the Williams Act[5] and return to a regime of Saturday Night Special raids—offers that are open for a very brief period, with no withdrawal rights.[6]

A second implication of the debate concerns the role of a target's management. All the participants in this exchange agree that management should be barred from obstructing tender offers. Gilson and I, however, endorse allowing management to provide information to potential competing acquirers, while Easterbrook and Fischel advocate requiring management to be passive.

In sum, I support a legal rule that: (1) regulates offerors in order to provide time for competing bids and (2) allows incumbent management to solicit such bids by supplying information to potential buyers. In my previous article, and in this exchange, I refer to this rule as "the auctioneering rule."

I should like to remark that Easterbrook and Fischel's vision of the appropriate takeover rules sharply diverges from the one that I offer. Professor Gilson, in his contribution to this exchange, expresses the view that the difference between him and Easterbrook and Fischel is far less important than their agreement that obstructive defense tactics should be prohibited.[7] Professor Gilson's analysis, however, focuses on the role of a target's management, and his view

4. *See* Bebchuk, *supra* note 3; Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819, 870-75 (1981).

5. 15 U.S.C. §§ 78*l*(i), 78m(d)-(e), 78n(d)-(f) (1976).

6. The Williams Act and the rules that the SEC promulgated on its basis prescribe a period for which offers must remain open and a period during which tendered shares may be withdrawn. *See* notes 64, 71 *infra*.

7. *See* Gilson, *Seeking Competitive Bids Versus Pure Passivity in Tender Offer Defense*, 35 STAN. L. REV. 51, 52, 66 (1982).

should be understood in this light. The question of whether management should be allowed to provide information to potential buyers is indeed of limited importance: As long as a regulatory delay is provided, an active competition among acquirers will take place even if management must remain passive. But the prescription of this crucial delay, which Easterbrook and Fischel oppose and I endorse, is of great moment. Taken as a whole, the system of low-premium Saturday Night Special raids that they endorse is very different from the competitive market for acquisitions that I support.[8]

8. In response to the above remarks, Professor Gilson elaborated his position with respect to the importance of the present debate. *Id.* at 66 n.36. Professor Gilson believes that the consensus on prohibiting obstructive tactics is far more important not only than the issue of allowing management to solicit bids, but also than the issue of allowing Saturday Night Special raids. Gilson does not doubt that a regulatory delay is essential for competing tender offers. Rather, he holds that banning obstructive tactics would make the whole question of facilitating competing offers recede in importance. Prohibiting obstructive tactics would convince the management of a potential target that it cannot remain independent, thus pushing the management to seek a negotiated sale of the company. Therefore, Gilson suggests, such a prohibition would lead to a replacement of unsolicited takeovers by negotiated acquisitions. And Gilson believes that this replacement would diminish the importance of the auctioneering rule.

I respectfully disagree with Professor Gilson. While below I question Gilson's prediction that prohibiting obstructive tactics would decrease the incidence of unsolicited takeovers, my view does not depend on the way in which acquisitions are consummated. The crucial point is this: The auctioneering rule has an important and desirable effect not only on unsolicited takeovers, but also on negotiated acquisitions. As I explain below, the rule substantially affects all negotiated acquisitions because such acquisitions take place against the background of a possible unfriendly tender offer by the acquirer or by a competing potential buyer.

First, the rule of auctioneering serves as a check on a self-serving management. In pursuing a negotiated sale, management might be concerned not only with the shareholders' interests but also with its own, different objectives. Management might choose as an acquisition partner not the company that values the target's assets most highly, but rather another company that is more likely to retain the management or present it with substantial personal benefits. Furthermore, whatever acquisition partner is chosen, management might approve in return for personal benefits a much smaller acquisition price than other potential buyers would be willing to pay. It is very difficult to prove that management's judgment has been skewed by self-interest, and the shareholders are quite vulnerable to such abuses.

A tainted acquisition agreement, however, is subject to the threat that another potential buyer might initiate a tender offer before the acquisition is consummated. And the auctioneering rule enables this threat to provide an effective check on the self-serving management and its partner. Time is obviously necessary for tender offers by rival potential buyers. The consummation of a merger usually requires at least two months because a shareholders' vote of approval is necessary. Disloyal management and its partner might therefore pursue the route of a friendly takeover in order to accelerate consummation of the acquisition. Indeed, in recent years the use of friendly takeovers for this purpose has greatly increased. The regulatory delay prescribed by the auctioneering rule ensures that, even in this scenario, potential competing buyers will have time to initiate rival tender offers. The rule thus assures that no acquisition can be consummated without time available for such offers. Hence, if management chooses an acquisition partner other than the highest-valuing user, or approves a price

In their contribution to this exchange, Easterbrook and Fischel subject my analysis of the auctioneering rule to a detailed and stimulating criticism. This article both responds to their criticism and extends the arguments that I presented in support of that rule. Part I examines the appropriate normative perspective from which to review the rule. Part II deals with the effects that competition among acquirers has on search, and part III with the other effects of such competition. Part IV discusses the elements of the auctioneering rule. Finally, part V places the rule in a broader perspective: The rule should be viewed as a part of a legal framework intended to enable the dispersed shareholders of a takeover target to function as a sole owner would.

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lower than the competitive one, the rule will lead to a bid by a rival potential buyer and secure a competitive acquisition price and a competitive allocation for the target's assets.

Second, the auctioneering rule has a substantial effect even when management, in pursuing a negotiated acquisition, is solely or mainly concerned with the shareholders' interests. If the auctioneering rule is abandoned, the prospective acquirer that is approached by management may well immediately launch a low-premium unfriendly Saturday Night Special raid. Even if the prospective acquirer elects to negotiate, the negotiated price will be substantially affected by abandoning the rule. This price is a result of bargaining between management and the acquirer, and impeding competing bids will significantly strengthen the acquirer's bargaining position; the acquirer will never be willing to pay more than it would have to spend in an unfriendly takeover. Thus, if the auctioneering rule is abandoned, even a loyal management will not be able to secure a competitive acquisition price, but only a much lower one.

In sum, the auctioneering rule creates competitive conditions not only in unsolicited takeovers but in all acquisitions. In mergers and takeovers, unfriendly acquisitions and negotiated ones, whether management is loyal or self-serving, the rule is essential for competitive allocation of targets' assets and competitive pricing of acquired companies. And if such competitive allocation and pricing are beneficial and important to both society and target shareholders—a view that Professor Gilson and I share—then it follows that the auctioneering rule is desirable and of great significance.

The preceding analysis demonstrates that facilitating competing tender offers has substantial and widespread effects regardless of the ratio of unfriendly acquisitions to negotiated ones. But the impact that prohibiting obstructive tactics would have on this ratio is by itself an interesting question. I am uncertain that, as Gilson predicts, such prohibition would replace unfriendly takeovers by negotiated acquisitions. Professor Gilson correctly points out that the prohibition would give the management of a potential target an increased incentive to seek a negotiated acquisition. At the same time, however, the prohibition would have a substantial countervailing effect. Management's present ability to employ obstructing tactics is a major reason why a prospective acquirer may negotiate rather than initiate an unfriendly tender offer. The prospective acquirer may fear that an unsolicited takeover bid will be obstructed and may therefore seek management's approval of its acquisition. Moreover, the prospective acquirer may even try to ensure that management will obstruct any tender offers that other potential buyers might initiate. Thus, prohibiting obstructive tactics would greatly reduce the value to a prospective acquirer of management's approval, and may therefore decrease the proportion of negotiated acquisitions.

I. The Normative Perspective

My previous article examined the auctioneering rule from the perspectives of both target shareholders and social wealth. While I find the latter perspective more congenial, I also examined the former perspective because it was the one on which Easterbrook and Fischel focused.

In considering the perspective of target shareholders, I followed the approach that Easterbrook and Fischel took in their initial article. They correctly pointed out that we should not examine the interests of a target's shareholders ex post (after the offer has been made), when they are only interested in maximizing the premium, but ex ante. Ex ante, they suggested, the target's shareholders would have been interested in *both* the premium expected in an acquisition and the probability of an acquisition.[9] I then pointed out that the increase in premiums brought about by the auctioneering rule is likely to be very large relative to the rule's adverse effect on acquisition frequency.[10] I demonstrated that if competing bids are impeded, premiums will plummet not only in hostile takeovers, but in friendly takeovers and mergers as well.

Easterbrook and Fischel now suggest a new and interesting interpretation of the target shareholders' perspective.[11] They point out that ex ante a target's shareholders would have taken into account the possibility that their company will turn out to be an acquirer rather than a target. Consequently, they argue, ex ante the target's shareholders would have been indifferent to the distribution of takeover gains between acquirers and targets and would have been interested only in maximizing takeover frequency.[12]

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9. *See* Easterbrook & Fischel, *The Proper Role of a Target's Management*, *supra* note 1, at 1178 n.44 (formally stating the ex ante objective of target shareholders).

10. *See* Bebchuk, *supra* note 3, at 1034-45.

11. *See* Easterbrook & Fischel, *Auctions and Sunk Costs*, *supra* note 2, at 7-9.

12. In their initial article, Easterbrook and Fischel argued that if the shareholders of a given company were able to organize (i.e., if impeding transaction costs did not exist), they would adopt an article of incorporation prohibiting their management from soliciting competing bids in the face of a tender offer. Such an article would be in the shareholders' interest, Easterbrook and Fischel believed, because the article's upward effect on the probability of the company being taken over would outweigh its downward effect on the premium expected in such an event. *See* Easterbrook & Fischel, *The Proper Role of a Target's Management*, *supra* note 1, at 1180-82. I suppose that Easterbrook and Fischel's new approach to the target shareholders' perspective means that they no longer advance the above claim. They do not suggest now that the downward effect auctioneering has on takeover frequency outweighs its upward effect on acquisition premiums. Rather, they now argue that a company's shareholders would prefer a no-solicitation rule because the expected loss if their company becomes a target is offset by the expected gain if the company becomes an acquirer and the management of its

Easterbrook and Fischel correctly observe that targets were not destined to be targets and could have become acquirers. They incorrectly assume, however, that every company is *exactly* as likely to turn into an acquirer as to turn into a target. As I explain below, a company's probability of becoming an acquirer might well differ from its probability of becoming a target.

There are characteristics that make companies less likely to be targets or more likely to be acquirers. Large size is an example of such a characteristic. Size lowers the probability of a takeover[13] because it is difficult, though not impossible, for a company to take over a larger company. To be sure, the recent acquisitions of Conoco and Marathon demonstrated that large size might not provide immunity from a takeover. Perhaps even Mobil might be subject to a takeover. But there is little doubt that Mobil is less likely to be a target than to be an acquirer. Another example of such a characteristic is provided by firms that have an announced acquisition program or pursue a systematic acquisition policy—such firms are more likely than others to become acquirers.[14]

Similarly, there are characteristics that make companies more likely to be targets.[15] Indeed, even the very attributes that create a potential for beneficial acquisition—like poor management or prospects of synergy—may well be detected by the market. Market professionals do subject publicly traded companies to a continuous and intensive study. Easterbrook and Fischel are correct in noting that investors cannot identify with confidence firms that will be shortly taken over.[16] Investors, however, can identify companies as being more likely than average to be targets. As Easterbrook and Fischel originally observed, the price of a company's stock includes a compo-

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target is prohibited from auctioneering. Thus, it is no longer claimed that the company's shareholders would approve an isolated prohibition on their management. Instead, the present argument is that the shareholders would accept such a prohibition in return for and conditional on all other companies becoming subject to a similiar prohibition.

13. *See, e.g.*, Singh, *Take-Overs, Economic Natural Selection, and the Theory of the Firm: Evidence from the Postwar United Kingdom Experience*, 85 ECON. J. 497 (1975) (reporting that the likelihood of being taken over is greater for small firms than for large firms).

14. *See* Schipper & Thompson, The Impact of Merger-Related Regulations on the Shareholders of Acquiring Firms (June 1981) (unpublished manuscript). They find that the enactment of the Williams Act, which substantially increased premiums, was associated with negative effects on the stock of companies with acquisition programs.

15. *See, e.g.*, Stevens, *Financial Characteristics of Merged Firms: A Multivariate Analysis*, 8 J. FIN. & QUANTITATIVE ANALYSIS 149 (1973) (identifying financial characteristics that distinguish acquired firms and thus provide a means of comparing firms' likelihood of being taken over).

16. *See* Easterbrook & Fischel, *Auctions and Sunk Costs*, *supra* note 2, at 8 & n.17.

nent representing the premium expected in a takeover multiplied by its probability.[17] And it is highly doubtful that this component is equal for all companies.

In sum, a company is unlikely to face an equal probability of becoming a target and an acquirer. Some companies are more likely to become an acquirer than a target, others are more likely to become a target than an acquirer. And more targets belonged ex ante to the latter category than to the former.

Easterbrook and Fischel also suggest an alternative basis for their claim that, ex ante, all target shareholders would have attached no value to an increase in premiums.[18] They argue that shareholders hold diversified portfolios of stock, and that this diversification gives them an expectation of being with equal frequency on both sides of takeovers. A shareholder who holds shares of a company that is likely to be a target might also hold shares of companies that are likely to be acquirers. The problem with this argument, of course, is that many shareholders do not own portfolios, or at least not portfolios sufficiently diversified for the argument to hold.

Easterbrook and Fischel answer that all investors could hold diversified portfolios if they so desired, but some of them prefer and freely choose to forgo diversification. But it is unclear how this answer is supposed to support Easterbrook and Fischel's present view of the interests of target shareholders. Shareholders who hold only the shares of a company that is more likely to be a target than an acquirer do value an increase in expected takeover premiums. That these shareholders could have diversified and that their view would then have changed is of little relevance when one considers which rule is desirable from their perspective.

Thus, Easterbrook and Fischel's observations—that targets might have become acquirers and that shareholders might hold diversified portfolios—do not justify their conclusion that, ex ante, all target shareholders would have been indifferent to a rule's effect on premiums. To be sure, some target shareholders (those, say, who hold perfectly diversified portfolios) would have been indifferent to this effect. But there are many target shareholders who ex ante would have valued an increase in premiums, and there are even some who ex ante would have valued a decrease, though the latter category is clearly less numerous than the former. Thus, Easterbrook and Fischel's present interpretation of the target shareholders' perspective should not

17. Easterbrook & Fischel, *The Proper Role of a Target's Management*, *supra* note 1, at 1164.

18. *See* Easterbrook & Fischel, *Auctions and Sunk Costs*, *supra* note 2, at 8–9.

be accepted. The auctioneering rule's substantial effect on premiums *is* of great significance when the target shareholders' perspective is examined.

In any event, I shall demonstrate in this article that the auctioneering rule is desirable to target shareholders even if Easterbrook and Fischel's present interpretation of their perspective is accepted. Under this interpretation, the desirable rule is one which maximizes the gains that takeovers confer on both targets and acquirers, regardless of how these gains are distributed. Because this interpretation of the target shareholders' perspective seeks to maximize the total value of corporate assets, I shall refer to it as the perspective of corporate wealth.

A second perspective which I shall consider, as I did in my earlier article, is that of social wealth.[19] I wish to note that under Easterbrook and Fischel's present interpretation, the perspective of target shareholders becomes very similar to that of social wealth. Consequently, most of the consequences that my earlier article pointed out as beneficial from the social wealth perspective are also beneficial from the corporate wealth perspective. The main difference between the two perspectives is that corporate gains from tax savings and enhanced market power count as a benefit from the corporate wealth perspective but not from that of social wealth. And one reason for favoring the social wealth perspective is that shareholders are also consumers, taxpayers, and beneficiaries of government services, and this fact would have figured in their ex ante considerations.

II. The Effect of Facilitating Competing Bids on Search

Easterbrook and Fischel rest their case on a claim that, because the auctioneering rule decreases the amount of search by prospective acquirers, it reduces the number of beneficial acquisitions. First bidders incur costs that subsequent bidders do not bear, and the rule lowers the reward for being a first bidder. I acknowledged that the rule produces a decrease in search by prospective acquirers. I suggested, however, that the rule's overall effect on the number of offers might be desirable; and that in any event whatever undesirable effect the rule might have is unlikely to be substantial. I made three claims: (1) the decrease in prospective acquirers' search is unlikely to produce a substantial decrease in buyer-initiated beneficial acquisitions; (2) the decrease in prospective acquirers' search may be desira-

19. *See* Bebchuk, *supra* note 3, at 1046-50.

ble; and (3) the auctioneering rule produces a desirable increase in prospective sellers' search and consequently in the number of seller-initiated beneficial acquisitions. Easterbrook and Fischel deny all three claims.

A. *The Magnitude of the Decrease in Buyer-Initiated Beneficial Acquisitions*

In their initial article, Easterbrook and Fischel expressed a concern that the auctioneering rule might all but deny first bidders any return on their search costs, and thus might severely curtail search by prospective acquirers.[20] I responded by pointing out that the auctioneering rule is consistent with searchers receiving substantial returns relative to search costs.[21]

I first suggested three ways in which searchers earn significant returns under the prevailing rule of auctioneering. For example, a searcher can, prior to its bid, purchase in the market up to five percent of the target's stock without being required to disclose the purchase;[22] whatever the outcome of a subsequent bidding contest, the searcher will earn on its pre-offer purchase a profit that might well reach two to four percent of the target's value.[23] If it seems desirable to enhance the return on search, a substantial increase in searchers' profits on pre-offer purchases can be accomplished by a limited raise in the percentage of the target's stock that may be purchased without disclosure.[24] Easterbrook and Fischel now accept

20. *See* Easterbrook & Fischel, *The Proper Role of a Target's Management*, *supra* note 1, at 1177-79.

21. *See* Bebchuk, *supra* note 3, at 1034-38. *See also* Gilson, *supra* note 4, at 870-71.

22. As amended, section 13(d)(1) of the Williams Act requires any person who obtains more than five percent of a company's stock to file with the SEC. 15 U.S.C. § 78n(d)(1) (1976).

23. *See* Jarrel & Bradley, *The Economic Effects of Federal and State Regulations of Cash Tender Offers*, 23 J.L. & ECON. 371 (1980) (the average takeover premium in 1968-1977 was 52.8% for takeovers not subject to state tender offer statutes, and 73.1% for takeovers subject to such statutes).

In addition to a searcher's opportunity to invest profitably in the stock of targets that it discovers, I described two other rewards for search. First, a searcher may discover a target whose assets it values more highly than do other potential buyers. In such a case a bidding contest will leave the searcher with a surplus, for it will not have to pay as much as its own valuation of the target. The surplus may be substantial because acquirers may vary substantially in their valuation of a target. Second, the first bidder may have a strategic advantage by virtue of being the first to commit itself to a possible contest. *See* Bebchuk, *supra* note 3, at 1036 & n.45.

24. If, for example, the current disclosure threshold of 5% is raised to 10%, searchers' profits on pre-offer purchases will double and thus may well reach 4-8% of the value of the target involved.

that the auctioneering rule does not eliminate substantial incentives to search.[25] They are still concerned about the "magnitude . . . of the problem," however, because they disagree with my second suggestion—that the first bidder's unique costs are not at all large.[26]

I pointed out that the search for targets is usually carried out by investment bankers. Thus, the search costs are commonly a fraction of the investment banker's overall fees, which, in turn, usually are less than one percent of the target's value and contingent upon the success of the acquisition attempt.[27] Easterbrook and Fischel say that this does not exhaust the first bidder's costs. They suggest that bidders must assemble and hold capital at the ready, and that the first bidder's capital is committed for the longest time. Bidders, however, usually do not back their cash tender offers with cash reserves, but rather establish an adequate credit line. And the costs of maintaining such a credit line for an additional month are on the order of one-tenth of one percent of the available credit.[28]

Easterbrook and Fischel also suggest that there are opportunity costs to the time spent by the first bidder's managers. The managers, however, do not usually participate in the search that leads to the identification of targets. Of course, once a target is identified, the managers may spend considerable time in deciding whether to make a bid, with what premium, and so on. But the managers of subsequent bidders will have to make similar decisions. The first bidder therefore does not seem to bear any special cost in management time for which it has to be rewarded.[29]

The preceding analysis clearly suggests that the auctioneering

25. *See* Easterbrook & Fischel, *Auctions and Sunk Costs*, *supra* note 2, at 3-7.

26. *See id.* at 6-7.

27. *See* Bebchuk, *supra* note 3, at 1037, and sources cited in *id.* at nn.47-48.

28. In return for a line of credit, banks typically require that the potential borrower maintain an interest-free demand deposit equal to 10% of the funds potentially available under the credit line. *See* R. BREALEY & S. MYERS, PRINCIPLES OF CORPORATE FINANCE 623 (1981). The cost of maintaining the credit line for an extra month is the foregone monthly interest on that deposit—which would amount to about .1% of the total credit available.

29. Easterbrook and Fischel also note that a searcher making a hostile bid may have some disadvantage in comparison to a subsequent bidder that receives nonpublic information from the target's management. They argue that this possibility should be counted as part of the cost of searching for targets. Easterbrook & Fischel, *Auctions and Sunk Costs*, *supra* note 2, at 6 & n.13. But a searcher that discovers a target need not suffer from the above disadvantage. The searcher may well approach the target's management and negotiate an acquisition agreement, and consequently have an informational *advantage* over other potential buyers. Most acquisitions are indeed negotiated in this way. *See* Freund & Greene, *Substance over Form S-14: A Proposal to Reform SEC Regulation of Negotiated Acquisitions*, 36 BUS. LAW. 1483, 1485-86 (1981). Thus, a searcher that identifies a target is more likely to end up with an informational advantage than with a disadvantage.

rule is consistent with a substantial investment in prospective acquirers' search. The present considerable level of search is reflected in the large number of acquisitions that occur. And if the present level is deemed suboptimal, a considerable enhancement can be accomplished, as explained above, without abandoning the auctioneering rule. Of course, abandoning the rule would further encourage investment in search. But I should like to emphasize that there is a distinction between an increase in dollars spent on search and the resulting increase in the number of beneficial acquisitions.

The marginal effectiveness of search decreases as the level of search rises. After the easily identifiable targets are discovered, the well-hidden remain. Additionally, targets with large potential for gains from synergy or improved management are, on average, easier to identify than targets whose present profitability is close to its maximum potential value. Abandoning the auctioneering rule would undoubtedly increase the expenditures on search by prospective acquirers. Perhaps some novel and costly methods of search would be adopted. But, since the current level of search is substantial, it is doubtful that this increase in expenditures would substantially increase the number of beneficial acquisitions. This is an application of the marginal analysis to which Easterbrook and Fischel allude.[30]

B. *Is the Decrease in Search by Prospective Acquirers Undesirable?*

To induce the search level that is optimal from a given perspective, the private gains of searchers must be equal at the margin to the benefits, from that given perspective, of their activity. If competing bids are impeded, a searcher-acquirer will capture almost all the stock market gains accompanying the takeover. In this situation, I argued, searchers will receive a number of private rewards that do not entirely represent social gains, and this will possibly induce a socially excessive level of search.[31]

Easterbrook and Fischel contest my argument by denying that private rewards that do not fully represent social gains might have any motivating role in takeovers.[32] They claim in particular that this is ruled out by the empirical evidence. The data, however, does not seem to support their claim. All that it indicates is that takeovers are accompanied by an increase in the combined stock market value of

30. *See* Easterbrook & Fischel, *Auctions and Sunk Costs*, *supra* note 2, at 7.

31. *See* Bebchuk, *supra* note 3, at 1046–48.

32. *See* Easterbrook & Fischel, *Auctions and Sunk Costs*, *supra* note 2, at 10–12.

the acquirer and the target.[33] And, as I explained in my earlier article, all the motives whose existence I suggested are both consistent with the empirical evidence and rooted in a sound theoretical basis.[34]

First, I suggested that an acquisition may be motivated by the prospect of tax savings or an increased market power. Such "synergistic" gains increase post-tax profits and are thus in line with the evidence on stock market gains. All the reasons that suggest that some takeovers may be explained by real synergistic gains (such as economies of scale) also indicate that some may be motivated by tax benefits and enhanced market power. Since Easterbrook and Fischel now accept that acquisitions may be motivated by real synergistic gains, they should also recognize the tax savings and market power motives.

Second, I pointed out that an acquisition may be motivated by foreknowledge—the acquirer may have information suggesting that the target's stock is currently undervalued. The recent wave of bids for oil companies, for example, was widely viewed as taking place because the prices of their shares did not fully reflect the values of their oil reserves.[35] The takeover process is likely to lead the market to revise its valuation of the target, and thus to be accompanied by an increase in the combined stock market value of the target and the acquirer. Acquisitions motivated by foreknowledge are therefore consistent with the evidence on stock market gains. But the stock gains that accompany such acquisitions do not represent any newly created value.

Easterbrook and Fischel deny that an acquisition motivated by

33. The empirical evidence is cited in Easterbrook & Fischel, *The Proper Role of a Target's Management*, *supra* note 1, at 1187 n.69.

34. See Bebchuk, *supra* note 3, at 1030-34, where the motives for takeovers are analyzed in detail. Some aspects of this analysis are expanded below.

35. *See, e.g.*, *The New Urge to Merge*, NEWSWEEK, July 27, 1981, at 50, 54. Easterbrook and Fischel are so skeptical about the foreknowledge motive that they even doubt the existence of single manifestations of it. Mobil's president testified that, in seeking to acquire Marathon, Mobil was motivated by the undervaluation of Marathon's stock. Marathon Oil Co. v. Mobil Corp., 669 F.2d 378, 382 (6th Cir. 1981), *cert. denied*, 455 U.S. 982 (1982). Easterbrook and Fischel suggest that he possibly did not know or could not articulate the reason for the bid. Easterbrook & Fischel, *Auctions and Sunk Costs*, *supra* note 2, at 11 n.26. But it seems quite unlikely that, on a question crucial for the litigation, the president would have given such testimony, which predictably worked against Mobil, if Mobil had been motivated by the prospect of significant real gains. The contest over Marathon was eventually won by U.S. Steel, which paid a premium of above two billion dollars. U.S. Steel retained Marathon's management, and the acquisition produced no detectable synergistic gains, certainly not gains of the magnitude of that premium. All this clearly suggests that Marathon's stock had been undervalued prior to the contest.

foreknowledge might occur.[36] They reason that the target's managers will reveal the target's true value, its price will go up, and the shareholders will withhold their shares. This argument, however, ignores the pressure on shareholders to tender.[37] As a result of this pressure, the target's independence is doomed once a tender offer is made—the target will be acquired by the highest bidder even if many stockholders judge its offer to be less than the target's value as an independent entity. Following the announcement of the initial offer, the target's stock price will reflect the expectation that the target will be acquired by the highest bidder; the price therefore will exceed the initial offer's value only if a competing bidder is expected to enter the picture with a higher offer.

Moreover, I should like to emphasize that the relevant question here concerns not the present distribution of takeover motives but rather the distribution that would prevail if the auctioneering rule were abandoned. Whatever the current incidence of foreknowledge-motivated acquisitions, they would likely be very pervasive if the rule were abandoned. The rule discourages search for undervalued targets more than it discourages otherwise-motivated searches. In an acquisition motivated by the prospect of gains from synergy or improved management, the target's value is likely to vary among potential acquirers, and an auction will leave the winner with a surplus. But in an acquisition motivated by undervaluation, if the competition among acquirers is perfect, the winner will not be left with a surplus. If the auctioneering rule were abandoned, however, a searcher that identifies an undervalued target would be able to capture almost all of the difference between its present price and its true value; the search for undervalued targets would therefore be greatly encouraged.

In response to the above analysis, Easterbrook and Fischel make two additional arguments with respect to the foreknowledge motive.[38] First, they suggest that, if competing bids were impeded, there would not be many instances of difference between market price and real value. They say that even a small difference would lead sophisticated investors—those that invest resources in searches for undervalued companies—to react promptly. But what form will this reaction take? As I suggested above, if competing bids were impeded, identifying an undervalued company would often lead to an

36. *See* Easterbrook & Fischel, *Auctions and Sunk Costs*, *supra* note 2, at 10.

37. For a discussion of the pressure to tender, see note 3 *supra*.

38. *See* Easterbrook & Fischel, *Auctions and Sunk Costs*, *supra* note 2, at 10–12.

immediate Saturday Night Special raid, which would enable the raider to capture almost all of the difference between market price and real value. Indeed, Easterbrook and Fischel go on to say that a rule impeding auctions, by allowing tender offers to occur quickly and easily, would itself reduce any disparity between price and value to a small level.[39] But an argument that foreknowledge-motivated takeovers would not occur because foreknowledge-motivated takeovers would eliminate all disparities between price and value seems to contain an internal contradiction.

Alternatively, Easterbrook and Fischel emphasize that a foreknowledge-motivated takeover might produce a social benefit. When a searcher discovers and takes over a company that the market has undervalued, the takeover process may "correct" the market's valuation of the company. Although the adjustment in the market price would ultimately occur anyway, the acceleration of the adjustment is nonetheless socially beneficial. As I pointed out in my previous article,[40] however, the crucial point is that the value to society of the price correction is smaller, presumably much smaller, than the amount of the undervaluation. For example, the value to society of correcting a one billion dollar undervaluation in an oil company's price is less than one billion dollars; the correction has a value to society much smaller than that of an acquisition that would increase the oil company's *real* value by a billion dollars. Hence, if the auctioneering rule is abandoned, and the searcher captures almost all of the one billion dollar gap between the oil company's price and value, the searcher's private gain will presumably far exceed the social benefit that the searcher produces.

As Easterbrook and Fischel note,[41] many arbitrageurs, security analysts, and other market professionals do at present search for undervalued securities and contribute to the accuracy of the market pricing. These market professionals profit from their search by purchasing undervalued stock in the market, or by selling their information to others who will make such purchases. Thus, searchers currently capture part of the differences between price and value that they identify. And the present study of securities in search for undervalued ones is very intensive. It is difficult to determine whether the present substantial level of search for undervalued securities is socially excessive or suboptimal. But there can be little doubt that a

39. *Id.* at 11.

40. Bebchuk, *supra* note 3, at 1033.

41. Easterbrook & Fischel, *Auctions and Sunk Costs*, *supra* note 2, at 11.

rule impeding auctions would greatly expand this search to a socially excessive level.

Finally, I suggested that an acquirer's managers may be partly motivated by the prospect of expanding their firm's size. Managers' preference for expansion is widely accepted.[42] It is suggested by the basic economic premise that individuals seek to maximize their utility, because there is a clear link between a firm's size and its managers' remuneration, perquisites, power, and prestige.[43] Although the expansion motive may not dominate in many takeovers, it may often exist alongside other motives. I also wish to emphasize that this motive is quite consistent with the empirical evidence on takeovers.[44] Easterbrook and Fischel deny the existence of the expansion motive and argue that deviations from profit-maximization are penalized by the market for corporate control.[45] But unless they are prepared to argue that the monitoring process is *perfect*, they will have to recognize the presence of this motive.

In sum, there are several motives for takeovers, not a single motive. My analysis does assume that, on the whole, takeovers increase social welfare. But there is a strong theoretical and empirical basis for supposing that many takeovers are at least partially motivated by tax savings, enhanced market power, foreknowledge, and preference for expansion—private benefits that do not entirely represent social gains. Moreover, the proportion of foreknowledge-motivated acquisitions will substantially increase if the auctioneering rule is abandoned. Thus, if the rule is abandoned, the private rewards for search

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42. *See, e.g.*, Marris & Mueller, *The Corporation, Competition, and the Invisible Hand*, 18 J. ECON. LITERATURE 32, 40-45 (1980).

43. *See, e.g.*, Firth, *Takeovers, Shareholder Returns, and the Theory of the Firm*, 94 Q.J. ECON. 235, 254-58 (1980) (growth of assets through takeovers leads to increase in remuneration); McGuire, Chiu & Elbing, *Executive Incomes, Sales and Profits*, 52 AM. ECON. REV. 753 (1962) (remuneration levels of directors and senior management rise as the firm's size increases).

44. Some studies find that acquirers lose as a result of their acquisitions. *See, e.g.*, Firth, *supra* note 43, at 239-51 (U.K. data). Other studies find that the acquirers realize little or no gains. *See, e.g.*, Langetieg, *An Application of a Three-Factor Performance Index to Measure Stockholder Gains from Merger*, 6 J. FIN. ECON. 365, 381-82 (1978) ("[T]he small stockholder gain . . . suggests that perhaps another motive such as managerial welfare, may have also been an instrumental cause of the merger.").

Moreover, firms whose directors have small shareholdings effect more takeovers than firms whose directors have large shareholdings. *See* Firth, *supra* note 43, at 256-57. The smaller a director's shareholdings, the greater his inclination to deviate from value-maximization in favor of other objectives, such as expansion. This evidence thus suggests the presence of an expansion motive.

45. Easterbrook & Fischel, *Auctions and Sunk Costs*, *supra* note 2, at 11.

might well exceed, at the margin, its social benefit, and this will possibly induce a socially excessive level of search.

The level of search that impeding competing bids would induce might be excessive also from the corporate wealth perspective. Stock market gains that merely represent a correction of previous undervaluation, and managers' benefits from expansion—two private gains that would motivate some searchers—do not represent benefits when judged from that perspective.

C. *The Increase in Search by Prospective Sellers*

Acquisitions are a result not only of prospective acquirers' search but also of search by potential sellers. If acquisition of a company can produce gains, its management may look for an appropriate buyer and initiate acquisition negotiations. I suggested that, because the auctioneering rule substantially increases premiums in negotiated acquisitions, it provides incentives to search by potential sellers.[46] The rule affects these premiums because they are negotiated against the background of a possible unfriendly tender offer by the prospective acquirer. Impeding competing bids would greatly strengthen the prospective acquirer's bargaining position; the prospective acquirer would not be willing to pay more than the low premium it would have to spend to acquire the target through an unfriendly takeover. Therefore, impeding competing bids would curtail the incentives to prospective sellers' search, and thus would decrease the number of seller-initiated beneficial acquisitions. The reduction in prospective sellers' search would likely be undesirable because such searches are not motivated by a preference for expansion or by a current undervaluation of the seller's stock.

Easterbrook and Fischel disagree.[47] They note that their rule of managerial passivity would not bar management from searching for a buyer as long as a tender offer has not been made. And, they argue, managers dedicated to shareholders' interests would conduct such searches. This argument ignores, however, the fact that impeding competing bids would alter the interests of the shareholders of a prospective seller because the premium that they can expect from a sale would substantially decrease. As reducing premiums would increase the return on prospective acquirers' search, so it would reduce the return on prospective sellers' search. Impeding competing bids

46. *See* Bebchuk, *supra* note 3, at 1041-46.

47. *See* Easterbrook & Fischel, *Auctions and Sunk Costs*, *supra* note 2, at 12.

would thus shift rewards for search from sellers to acquirers. Therefore, it would discourage search by prospective sellers even assuming that their managers are concerned only with shareholders' interests.

Moreover, the curtailment of prospective sellers' search is likely to be especially drastic because a seller's managers may be also concerned with their own, private interests. The managers are likely to value their independence. An acquisition that generates a substantial premium may nonetheless be in the management's overall interest, because management may have incentives to increase the firm's value. But a low-premium acquisition, as acquisitions will be if competing bids are impeded, is unlikely to serve the seller's management. Thus, impeding competing bids may well make a search for a buyer altogether undesirable to the management of a potential seller.

III. The Other Effects of Facilitating Competing Bids

Even if the auctioneering rule's effect on the number of beneficial acquisitions is undesirable, the case for the rule remains strong. The rule has other effects that are substantially beneficial from the perspectives of social wealth and corporate wealth.

A. *Allocation of Assets to Their Most Valuable Uses*

From the perspective of both social wealth and corporate wealth, it is desirable that a target's assets reach their highest-valuing user, and in the least costly way. I suggested that facilitating competition among acquirers serves this objective.[48] Impeding competing bids would substantially increase the likelihood that a target will be acquired by a firm other than the highest-valuing user. While such an acquirer may resell the target's assets to the highest-valuing user, this resale may involve delay and transaction costs and may never occur. Easterbrook and Fischel respond by claiming that resales may involve less friction than does the operation of the auctioneering rule.[49] I shall now therefore extend my earlier comments to explain why the auctioneering rule in all likelihood minimizes the friction involved in moving target assets to their best possible uses.[50]

1. *Uncontested bids.*

It is important to understand that the auctioneering rule per-

48. *See* Bebchuk, *supra* note 3, at 1048-49 & n.81. *See also* Gilson, *supra* note 4, at 872.

49. *See* Easterbrook & Fischel, *Auctions and Sunk Costs*, *supra* note 2, at 14-15.

50. For Professor Gilson's detailed defense in this exchange of his similar position on this question, see Gilson, *supra* note 7, at 62-64.

forms its allocational role not only in cases where an auction actually takes place, but also in those more numerous cases where no contest occurs. The rule substantially increases the likelihood that the first bidder for a given target will be the company to which the target's assets are most valuable. If competing bids are impeded, the first bidder, whether or not it is the highest-valuing user, will take over the target. Under the auctioneering rule, however, a company other than the highest-valuing user will have little chance of taking over the target even if it makes the initial offer. This fact will affect the actions of any party that might identify the potential benefit from the target's acquisition.

Suppose first that, as often happens, an investment banker studies the target on its own initiative, planning to interest a potential buyer later in the idea of an acquisition. Since investment bankers' fees are contingent on the success of the acquisition attempt, the auctioneering rule provides the investment banker with a strong incentive to look for the highest-valuing user, rather than to approach other potential buyers. Abandoning the rule would eliminate or sharply reduce this incentive to look for the highest-valuing user.

Suppose now that the target is identified by a searcher, Carl Icahn for example, that is motivated by the prospect of a speculative profit on the target's stock.[51] Under the auctioneering rule, Icahn will purchase a block of the target's stock, attract the market's attention to the target, induce a bid by the highest-valuing user, and then earn the takeover's premium on his block. If the auctioneering rule is abandoned, however, Icahn will not lead to an offer by the highest-valuing user, but will himself acquire the target through a Saturday Night Special raid with a minimum premium. By subsequently reselling the target to its highest-valuing user, Icahn will earn the premium not on a limited block but on all of the target's stock.

Next, suppose that the target is identified by a potential buyer other than its highest-valuing user, or by an investment banker searching on behalf of that potential buyer. The potential buyer will first purchase in the market a block of the target's stock, which is bound to appreciate if the target will be taken over. Then, if the potential buyer recognizes that it is not the highest-valuing user, the auctioneering rule may induce it not to make an acquisition attempt

51. Gilson uses Carl Icahn as an example of a searcher whose current strategy is to purchase a block of stock in a target that it identifies, attract potential buyers' attention to the target and lead to a premium takeover, and consequently earn a profit on its block of stock. See Gilson, *supra* note 7, at 60, for a discussion of these searchers.

that will likely fail, but instead to pass the information about the target to other potential buyers.

Finally, suppose that the target's own management initiates the acquisition. The management may view an acquisition by some company other than the highest-valuing user as best serving its own self-interest. But the auctioneering rule may induce management to approach the highest-valuing user rather than the other company.

The analysis is supported by the evidence that under the prevailing rule of auctioneering most tender offers are not contested.[52] Thus, there are probably many cases at present where the first bidder is the highest-valuing user only because of the rule. In these cases the rule leads to an efficient allocation of assets without any transaction costs being incurred beyond the unavoidable costs of the first bid. And abandoning the auctioneering rule would necessarily add friction in these many cases, no matter how limited the friction involved in a resale.

2. *Contested bids.*

The discussion above suggests that, overall, the auctioneering rule may well minimize the friction involved in moving assets to their best uses even if actual contests, which occur only in a minority of takeovers, prove costlier than resales. But in any event, there is a strong basis for believing that an auction involves, on average, less friction than would relying on the acquirer to resell the target's assets to the highest-valuing user.

The main problem with the resale scenario is not the "mechanical" costs involved in a resale but the danger that a resale will not take place. First, as in any bargaining situation between potential buyer and seller, strategic behavior may deadlock the negotiations between the acquirer and the highest-valuing user and thus prevent the resale.[53] More importantly, the acquirer's managers may decide to retain the target's assets to avoid reducing the size of the enterprise under their control. As already noted, it is widely accepted that managers' business decisions may be affected by their preference for expanding the firm's size.[54] Easterbrook and Fischel point out that many firms do sell divisions, and argue that managers will not turn

52. *See, e.g.*, Bradley, *Interfirm Tender Offers and the Market for Corporate Control*, 53 J. BUS. 345 (1980); Dodd & Ruback, *Tender Offers and Stockholder Returns*, 5 J. FIN. ECON. 351 (1977).

53. *See, e.g.*, Polinsky, *Controlling Externalities and Protecting Entitlements: Property Right, Liability Rule, and Tax-Subsidy Approaches*, 8 J. LEGAL STUD. 1 (1979).

54. *See* note 42–43 *supra* and accompanying text.

down a profit from selling a division any more than they will reject a profit from selling products.[55] But selling products does not reduce a firm's size, while a sale of a division does. And the fact that divisions are often sold does not imply that managers take advantage of all, or even most, opportunities for such sales. In sum, there is a far from trivial risk that the target's assets will not reach their most valuable use via resale, and this risk clearly represents a substantial cost.[56]

An auction, in contrast, ensures that the target's assets will reach the highest-valuing user. And the "mechanical" costs of an auction are generally quite small relative to the value of this efficient allocation. I wish to emphasize that these costs should not be judged by the example of past bidding contests. Most of the fanfare and waste that accompanied these contests was the result of obstructive defense tactics, and prohibiting these tactics would eliminate such costs. The only costs intrinsic to the auctioneering rule's operation are the costs of making competing bids, and these costs are a small price to pay for the efficient allocation of targets' assets.

B. *Incentives to Capital Investment*

To induce optimal levels of capital investment in given companies, shareholders must receive exactly the gains that result from their investment. The gains that an acquisition produces are attributable not only to the preceding search but also to the target's existence, and thus to individuals' prior decisions to establish and invest in the target. The auctioneering rule provides a target's shareholders with a larger share of the gains attributable to the target's existence. And to the extent that the acquirer has unique characteristics enabling it to produce greater gains than others, the rule provides its shareholders with those gains that are attributable to these unique characteristics and thus to their company's existence.[57] Therefore, I

55. *See* Easterbrook & Fischel, *Auctions and Sunk Costs*, *supra* note 2, at 14-15.

56. Easterbrook and Fischel argue that if the acquirer does not resell the target's assets, either because its managers prefer not to reduce their firm's size or because acquisition negotiations reach a deadlock, the acquirer itself will be subject to a takeover by the highest-valuing user. *See* Easterbrook & Fischel, *Auctions and Sunk Costs, supra* note 2, at 15 n.31. As I pointed out, however, because the takeover mechanism is imperfect and frictional, not every company holding some assets that are more valuable to another firm will be taken over. Note, for example, that to obtain the target's assets, the highest-valuing user (which may be smaller than the acquirer) will have to take over the acquirer in its entirety (a takeover that may create antitrust problems), and then divest itself of the "original" acquirer. *See* Bebchuk, *supra* note 3, at 1048 n.81. *See also* Gilson, *supra* note 7, at 64.

57. A bidding contest requires the acquirer to pay only slightly more than the target's value to other potential buyers. Thus, the acquirer captures the difference between its own

suggested, the rule moves us closer to the optimal levels of investment in given companies.[58]

Easterbrook and Fischel object on two grounds. First, they argue that targets cannot be identified in advance, and that therefore redistributing takeover gains from acquirers to targets cannot affect ex ante investment decisions.[59] As I already pointed out, however, many companies do face different probabilities of becoming targets and acquirers.[60] The auctioneering rule thus affects the share values of these companies, and brings their shareholders closer to facing the *expected* social gains from their investment. Abandoning the rule would therefore lead to underinvestment in companies that are more likely to be targets and to overinvestment in companies that are more likely to be acquirers.

For example, because size may decrease the probability of a takeover, abandoning the rule would lead, on average, to an underinvestment in small companies and an overinvestment in huge ones. To take another example, consider a high-tech company that is developing new products and, if successful, will likely be acquired by a larger concern because of the synergistic benefits of such a combination. Abandoning the auctioneering rule would substantially decrease the premium that the company's initial investors can expect in a future acquisition of their company, whether through a hostile takeover or a negotiated acquisition. Consequently, because the initial investors would not expect to capture the social value of their company's potential for producing synergistic gains, investment in the company would be suboptimal.

Easterbrook and Fischel's second argument denies the desirability of the effect that I suggest the auctioneering rule has on capital investment.[61] They claim in particular that investment in companies that are more likely to be targets should not be encouraged. But the desirability of the rule's effect is based on the same reasoning that Easterbrook and Fischel rely on to suggest that rewarding target search is desirable. To induce the optimal level of search, they say, searchers should capture the social value of their activity. The same logic suggests that to induce optimal levels of capital investment, shareholders should be provided with the social gains resulting from

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valuation of the target and the target's value to other buyers. This difference represents those gains from the acquisition that only the acquirer can produce.

58. *See* Bebchuk, *supra* note 3, at 1049.

59. *See* Easterbrook & Fischel, *Auctions and Sunk Costs*, *supra* note 2, at 12.

60. *See* notes 12-17 *supra* and accompanying text.

61. *See* Easterbrook & Fischel, *Auctions and Sunk Costs*, *supra* note 2, at 12.

their investment. Because facilitating competing bids does exactly that, it necessarily moves us closer to the optimal investment levels in any given company.

C. *Information Underlying Acquisition Decisions*

A prospective acquirer may well approach a company's management and seek nonpublic information that will make it better able to judge whether an acquisition will be beneficial. I suggested that abandoning the auctioneering rule would induce prospective acquirers to launch an immediate bid rather than approach management for information.[62] This would increase the incidence of acquisitions that produce no gain or even a loss.

Easterbrook and Fischel argue that my claim accuses bidders of irrationality.[63] They point out that impeding competing bids would not prevent a prospective acquirer from approaching management for information, but would only expand the acquirer's options. Prospective acquirers, they say, will always choose the most advantageous strategy. The problem with this argument is that it does not distinguish between a prospective acquirer's optimal strategy and the strategy that is optimal from the perspective of social or corporate wealth. My claim is precisely that if the auctioneering rule is abandoned, these two strategies will likely diverge.

From the perspective of social wealth or corporate wealth, it is desirable that a prospective acquirer seek information from management whenever this may reduce the risk of error. But a prospective acquirer is interested not only in reducing the risk of error but also in decreasing the premium that it will have to pay. Consider, assuming that the auctioneering rule is abandoned, which strategy is most advantageous for a prospective acquirer. If the prospective acquirer launches an immediate hostile bid, the risk of error may be larger, but, facing no competition, the acquirer will have to pay only a low premium. If the prospective acquirer approaches management, the risk of error may be reduced, but at the cost of a potentially much higher premium, because management may start looking for other potential buyers. Therefore, since the prospective acquirer is interested in lowering the premium it will have to pay—a consideration that is irrelevant from the perspectives of social or corporate

62. *See* Bebchuk, *supra* note 3, at 1049-50.

63. *See* Easterbrook & Fischel, *Auctions and Sunk Costs*, *supra* note 2, at 13.

wealth—it is unlikely to seek information from management even if this can reduce the risk of error.

IV. The Elements of the Auctioneering Rule

A. *The Regulation of Offerors*

The essential and primary instrument for facilitating competing bids is the regulation of offerors. Most importantly, it is desirable to prescribe a delay period.[64] A target's dispersed shareholders are under pressure to tender. If they could act in concert, they presumably would often agree among themselves to hold out for some limited period and explore the possibility of a competing offer. Since transaction costs make such an agreement impossible, regulations are needed to secure the time that is crucial for competing bids. A regulatory delay period facilitates competing offers not only in the face of hostile bids, but also in friendly takeovers, where the threat of a competing bid is the main check on management and its partner. In addition to prescribing a regulatory delay, it is desirable to limit the amount of the target's stock that a prospective acquirer may purchase secretly. Allowing prospective acquirers to make an undisclosed purchase of some amount of stock is instrumental in inducing search for targets.[65] But this amount of stock should be limited, lest the searcher lock up the target for itself.[66]

Easterbrook and Fischel oppose any regulation of tender offers.[67] Their opposition is mainly based on their general thesis, which I have already addressed, that facilitating competition among acquirers is undesirable. They also suggest that the regulations I endorse have a problem independent of their adverse effect on search.[68] The purchase of a block of stock, they point out, is often instrumental in proxy contests. Therefore, they argue, the regulation that limits undisclosed stock purchases inhibits proxy contests. It is not clear, however, why this regulation has such an effect. The regulation does not inhibit purchasing a block of stock; it only requires that beyond some specified threshold such purchases be disclosed.

I should like to point out that repealing the Williams Act, as Eas-

64. The current federal regulation prescribes a 15 business day waiting period within which tendered shares can be withdrawn. 17 C.F.R. § 240.14d-7(a)(1) (1981).

65. *See* notes 22-24 *supra* and accompanying text.

66. Current federal regulation prescribes a limit of five percent of the target's stock. 15 U.S.C. § 78n(d)(1) (1976).

67. *See* Easterbrook & Fischel, *Auctions and Sunk Costs*, *supra* note 2, at 15-17.

68. *Id.* at 16-17.

terbrook and Fischel advocate, would have an additional undesirable effect beyond impeding competing bids. Without regulation, the total price paid by an acquirer would be divided quite unevenly among the target's shareholders. Investors vary substantially in their ability to react quickly in the face of a tender offer.[69] As I explain below, without regulation unsophisticated shareholders, who cannot react quickly, would receive a disproportionately small share of the total price paid for the target.

It is generally expected that, following the expiration of a successful tender offer, the value of nontendered minority shares will be lower than the offer's value.[70] For one thing, the acquirer is likely to effect a subsequent freezeout in which the value of the consideration paid to minority shareholders may be lower than the value of the offer. Thus, a shareholder's portion of the total acquisition price depends not only on the number of shares he holds, but also on the proportion of his shares that are successfully tendered. Consequently, allowing Saturday Night Special raids would disadvantage unsophisticated investors. Offers would be open only for a very brief period, and many unsophisticated shareholders would not be able to react—either to tender or to sell their shares in the market to arbitrageurs who would tender—prior to the offer's expiration. Moreover, to induce immediate tendering, bidders would make partial offers on a first-come first-served basis, and those unable to react quickly would have their shares rejected.

When a company is acquired through a merger, the consideration paid for the company is divided equally among the shareholders. The federal regulation of offerors ensures that the acquisition price in a takeover will be also more or less evenly distributed. It requires that offers remain open for a period long enough for most unsophisticated shareholders to react.[71] And it prescribes an equal treatment of all shareholders that tender within a specified period,[72] thus precluding first-come first-served offers and other schemes that provide favorable terms to shareholders who tender early.

69. *See* Nathan & Volk, *Developments in Acquisitions and Acquisition Techniques Under the Williams Act*, TWELFTH ANNUAL INSTITUTE ON SECURITIES REGULATION 159, 181-82 (1981); Welles, *Inside the Arbitrage Game*, 15 INSTITUTIONAL INVESTOR, August 1981, at 41, 46-51.

70. See Bebchuk, *supra* note 3, at 1039-40, for a detailed explanation of the reasons for this state of affairs. For an empirical confirmation, see Bradley, *Interfirm Tender Offers and the Market for Corporate Control*, 53 J. BUS. 345 (1980).

71. *See* 17 C.F.R. § 240.14e-1(a) (1982) (offers must remain open for at least 20 business days from the date of commencement).

72. *See* 15 U.S.C. § 78n(d)(6) (1976).

B. *The Role of Incumbent Management*

All the participants in this exchange agree that obstructive defense tactics should be prohibited; a target's shareholders should be completely free to accept the best offer made to them. While a target's management should not obstruct existing offers, I support allowing it to provide other potential buyers with information about the target. Providing information to potential competing buyers leaves the shareholders free to accept any offer. And although the regulatory delay may often enable competing bidders to come forward on their own, in many cases provision of information by management is likely to be helpful for facilitating competing bids.

Because Easterbrook and Fischel view competition among acquirers as undesirable, they would oppose allowing the provision of information to potential buyers even if managers were solely concerned with the shareholders' interests. But Easterbrook and Fischel do emphasize, presumably in order to raise an additional objection, the possibility that a management soliciting competing bids is motivated by self-interest.[73] My previous article, however, examined this possibility and demonstrated that it provides no reason for denying management the power to provide information to potential buyers.[74] As long as management cannot obstruct other contenders, a "white knight" will win a contest over the target only if it offers the largest premium. And if facilitating competing bids is desirable, then, regardless of the management's motives, it performs a beneficial role whenever it solicits a bid.

Easterbrook and Fischel also suggest that even if a ban on obstructive tactics is adopted, the auctioneering rule will still create a danger of obstructions.[75] During the regulatory delay period management continues to run the target's business and might succeed in disguising some obstructions as ordinary business activities. While I agree that under a prohibition on obstructive tactics management would still be able to disguise some obstructions, there is a strong basis for supposing that these obstructions would be exceedingly limited. All potent obstructive tactics—such as litigation against the offeror, acquisitions that create antitrust obstacles, lock-up arrangements with a white knight, and issuance of stock to a friendly party—can hardly be disguised. Of course, the danger of disguised obstructions will completely disappear if we eliminate the regulatory

73. *See* Easterbrook & Fischel, *Auctions and Sunk Costs*, *supra* note 2, at 12, 15.

74. *See* Bebchuk, *supra* note 3, at 1055-56.

75. *See* Easterbrook & Fischel, *Auctions and Sunk Costs*, *supra* note 2, at 15 & n.33.

delay period, but this would clearly be far too high a price to pay to eliminate this danger.

V. A General Framework

I should like to place the auctioneering rule that I advocate in a broader perspective. The rule should be viewed as an element of a legal framework that is intended to enable the dispersed shareholders of a potential seller to function as a sole owner would. Many public companies are characterized by a separation between management and ownership and by dispersed ownership. As a result, the market for corporate assets will not function without legal intervention as does the market for "ordinary" assets that have a sole owner-manager. This should be addressed by a legal framework consisting of three elements, each corresponding to a capability possessed by a sole owner facing an offer to buy.

First, a sole owner is free to accept any offer made to him to buy his assets. Where management and ownership are separate, however, management's actions might threaten the shareholders' freedom to accept offers. Management might use the powers that it has for running the company's business to preclude shareholders' acceptance of an offer. This problem should be addressed by the first element of the proposed framework—the structural principle, as articulated by Professor Gilson,[76] that bars management from obstructing offers made to the shareholders.

Second, a sole owner who receives an offer to buy his assets is capable of seeking better offers. He can delay accepting the original offer, and can provide information about his assets to other potential buyers. But a target's dispersed shareholders, under pressure to tender, cannot act in concert to secure a delay, and they have no access to the company's internal information. The auctioneering rule—the second element of the framework—addresses this problem. The rule secures a delay by regulating offerors and allows management, which has access to internal documents, to provide information to potential buyers.

Third, a sole owner is free not only to accept any offer but also to reject, at least temporarily, all offers made to him. The pressure to tender, however, impairs the ability of a target's dispersed shareholders to take this course of action. This problem should be addressed

76. *See* Gilson, *supra* note 4. *See also* Gilson, *The Case Against Shark Repellent Amendments: Structural Limitations on the Enabling Concept*, 34 STAN. L. REV. 775 (1982).

by the framework's third element—a set of legal rules that would enable a target's shareholders to decide freely whether or not a sale is in their interest. Putting forward such a set of rules is a goal towards which future research should be directed.

CONCLUSION

The analysis of this article supports the conclusions of my earlier article. First, facilitating competing bids increases in a number of ways the efficiency with which society's and shareholders' resources are used. It minimizes the friction in the allocation of targets' assets to their most valuable uses, provides appropriate incentives to investment in given companies, and improves the information underlying acquisition decisions.

Second, when competition among acquirers is examined from the target shareholders' perspective, significant weight should be attached to its substantial upward effect on acquisition premiums. Easterbrook and Fischel's present interpretation of this perspective should not be accepted: An increase in premiums would have been ex ante desirable to many, even if not all, target shareholders.

Third, there is a strong basis for questioning the existence, or at least the magnitude, of the adverse effect that Easterbrook and Fischel claim facilitating competing bids has on the number of acquisitions. At present, target searchers receive significant rewards relative to their costs, and consequently they conduct a substantial amount of search. If it is desirable to enhance rewards for target search, a considerable enhancement can be accomplished without impeding competing bids. Although impeding bids would further encourage prospective acquirers' search, the expansion of this search may be undesirable. In any event, it is unlikely that the resulting increase in buyer-initiated beneficial acquisitions would be substantial; and, furthermore, this increase would be counterbalanced by a decrease in seller-initiated beneficial acquisitions.

I already admitted in my earlier article that no conclusive proof can be offered that the positive effects of competition among acquirers outweigh its possibly adverse effect on the number of acquisitions.[77] Easterbrook, Fischel, and Gilson share this skepticism about the availability of conclusive proof.[78] As Easterbrook and Fischel note, however, legislatures and courts must act on the basis of the

77. Bebchuk, *supra* note 3, at 1051.

78. *See* Easterbrook & Fischel, *Auctions and Sunk Costs*, *supra* note 2, at 21; Gilson, *supra* note 7, at 66.